Following the Smart Money

CIM

Individuals seeking consistent and healthy annual returns have traditionally faced an uphill battle when compared with endowment funds, pension funds, life insurance companies and other institutional "smart money" investors.[1]

By way of example, the average individual invested in a blend of equities and fixed-income mutual funds achieved an annual return of only 2.7% over the decade ended December 31, 2016.[1] Over roughly the same period, the top 97 endowment funds generated annual returns of 4.6%.[2]

In addition to having a deep well of resources, institutional investors for several years have been employing Modern Portfolio Theory as a means to improve the prospects for better risk-adjusted returns in various market environments. Utilizing the theory, investors diversify their holdings across a range of assets to account for fluctuating economic conditions including changes in growth, inflation and interest rates to name a few.

The Rise of Real Assets for Diversification

The conventional asset classes of equities, fixed-income securities and cash typically make up a portion of institutional investor portfolios, as do alternative investments such as private equity, hedge funds and venture capital. But real assets, which include real estate, infrastructure – think toll roads and utilities, – timber and agriculture, are alternatives that have increasingly become critical components of the portfolios.

Fortunately, individuals can track and use the same strategies utilized by smart money managers overseeing the Harvard University and Yale University endowments, the California Public Employees Retirement System (CalPERS), and other institutional funds. The institutional investors publish annual reports detailing how much capital they allocate to various assets and report publicly traded security holdings to the Securities and Exchange Commission. What's more, individuals have more opportunities than ever to diversify and include alternative assets in their portfolios through available investment products that specifically target other types of real assets.

Of the alternatives, institutional investors as a whole have had an increased appetite for real estate during the last several years, particularly following the financial crisis in 2008. Because real estate follows its own unique cycle, it tends to show much less correlation to disruptions in equities and other markets. Pricing inefficiencies in the asset class, as well as opportunities to add value, can provide returns over long time horizons. Properties leased to creditworthy tenants can produce steady income potential and appreciation, which helps create a hedge against inflation.[3]

1) 23nd Annual Quantitative Analysis of Investor Behavior, Dalbar, Inc., 2017. 2) The Wealthiest U.S. Universities Got $26 Billion Richer Last Year, Time Money, January 2018.

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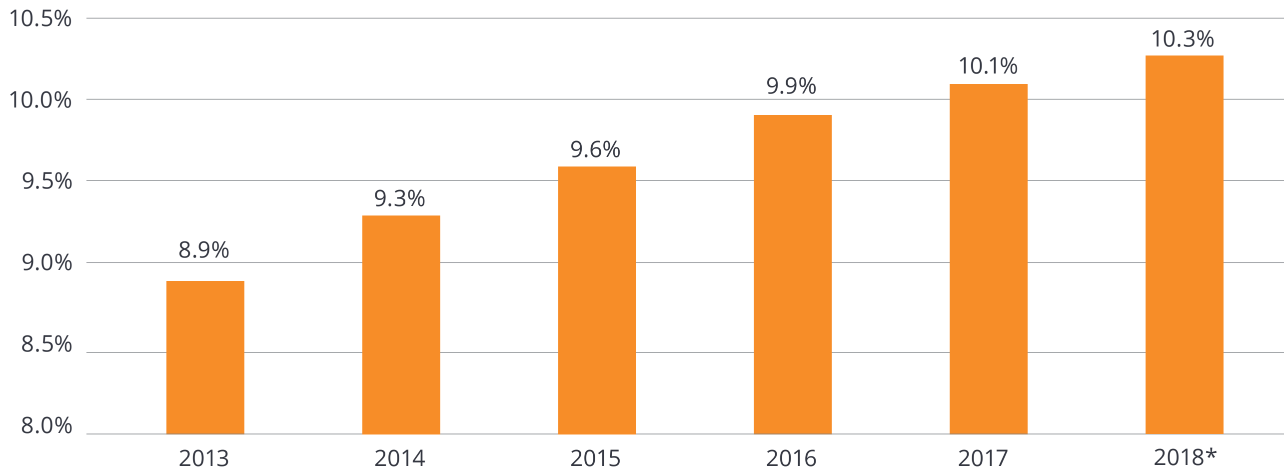
One annual survey of more than 200 institutional investors with aggregate assets under management of $11.5 trillion found that the funds had increased their real estate allocation to an average of 10.1% in 2017 from an average of 8.9% in 2013.[4] It also reported that the funds planned to increase their allocation to an average of 10.3% in 2018.[4] Similarly, an annual survey of public and private retirement plans, endowments, foundations, and other funds revealed that average real estate allocations had climbed to 9.0% in 2016 versus 8.8% in 2014.[5] What's more, that was up from 7.3% in 2011 and a mere 4.9% in 1996.[6]

Average Target Allocations to Real Estate

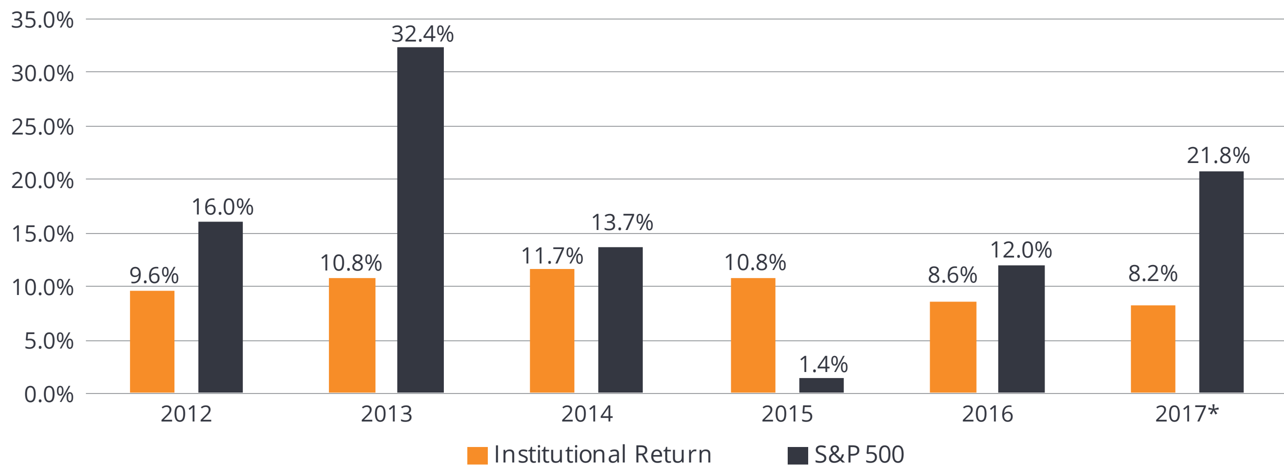
The average target real estate allocation among more than 200 institutional investors has been climbing over the past several years.



Source: Cornell University Baker Program in Real Estate and Hodes Weill & Associates, 2017 Institutional Real Estate Allocations Monitor.
** Estimate*

Real Estate Returns in Institutional Investor Portfolios

On average, real estate investments have contributed steady returns to the portfolios of more than 200 institutional investors.



Sources: Cornell University Baker Program in Real Estate and Hodes Weill & Associates, 2017 Institutional Real Estate Allocations Monitor. S&P 500 returns per Morningstar. Institutional real estate investments include direct investments, joint ventures, separate accounts, co-investments and real estate private funds.

** Shows target return for institutions and YTD as of 12/31/17 for S&P.*

3) There is no guarantee that shareholders will receive a distribution, and distributions may be paid from proceeds of the offering, and may be derived from borrowings, or from the sale of assets. Fees and expenses associated with the management of REITs will impact the ability to pay distributions and the effects of any capital appreciation. There is no guarantee that the shares of a REIT and its underlying properties will appreciate in value.

Ratcheting Up Real Estate

The fuller embrace of real estate represents a shift in how institutional investors view real estate. Prior to 1980, investment managers wouldn't hold properties in portfolios, but "experts today are suggesting that real estate is on the cusp of moving out of the alternative category and becoming the fourth mainstream asset class behind stocks, bonds and cash."[7]

The fact that on August 31, 2016 the Standard & Poor's Dow Jones Indices moved listed real estate companies from the Financials Sector to a newly created Real Estate Sector within its Global Industry Classification Standard would appear to support the argument. At the least, the decision reflects real estate's growth and importance in the economy. Some analysts suggest that the average real estate allocation among smart money investors could stabilize at around 20% in the coming years.[7]

Some funds that added real estate to their portfolios only a few years ago have quickly ratcheted up allocations. Norway Sovereign Wealth Fund Norges Bank Investment Management, for example, introduced real estate in 2011 and recently received approval from the country's finance ministry to raise the allocation to 7% from 5%.[8] Norges, which owns several U.S. properties, reported a real estate return of 7.5% in 2017, and the asset class has averaged a return of 6.2% since 2011.[9]

Like any investment manager, institutional funds have posted lower results or losses recently, but occasional down years are not unexpected in a flat market. Still, some of the more prominent funds continue to show positive – and in some cases, impressive – returns from real estate. In fiscal 2016, property investments generated a return of 13.8% for the $35.7 billion Harvard University endowment, which has a real

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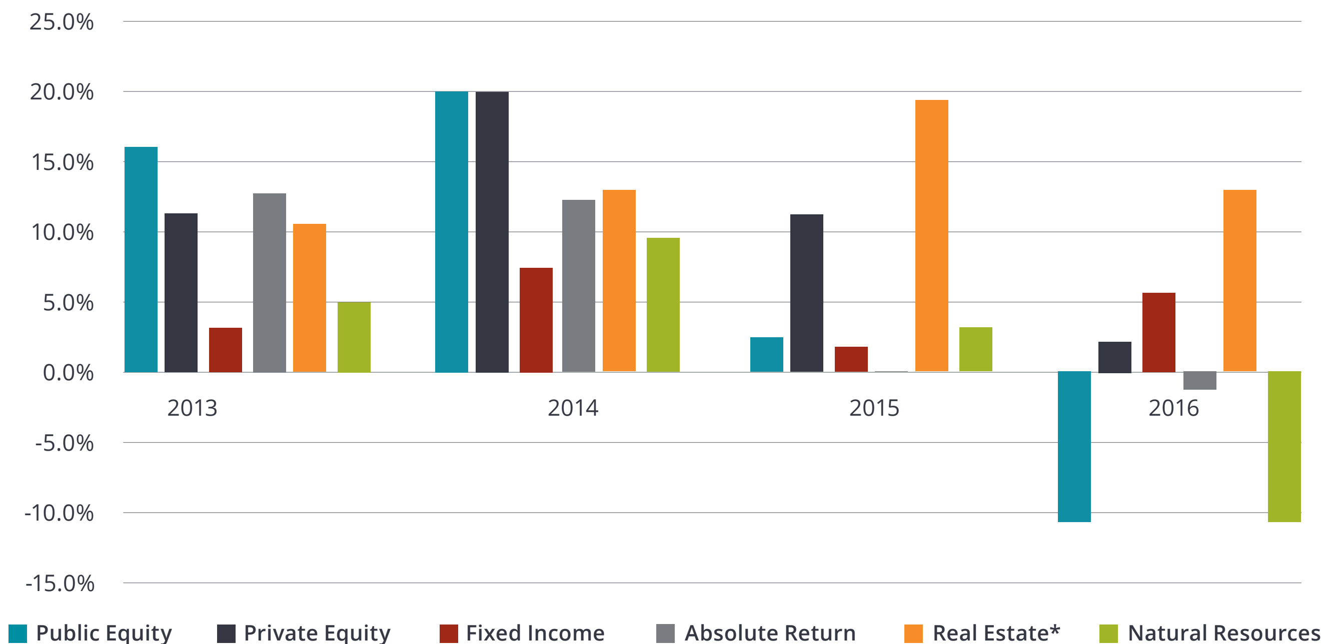
Harvard Portfolio Performance by Asset Class[13]



Source: Harvard Management Company Annual Endowment Reports
**Real estate portfolio encompasses direct activities and external fund investments.*

4) Institutional Real Estate Allocations Monitor, Cornell University Baker Program in Real Estate and Hodes Weill & Associates, 2017. 5) PREA Investor Report, Pension Real Estate Association, July 2017. 6) PREA Investor Report, Pension Real Estate Association, August 2012. 7) Real Estate Takes Its Place as the Fourth Asset Class, NAIOP and The Commercial Real Estate Development Association, Spring 2015. 8) Norway Ministry of Finance, April 2016. 9) Government Pension Fund Global Report, Norges Bank Investment Management, 2017. 10) Annual Endowment Report, Harvard Management Company, September 2016. 11) Annual Endowment Report, Harvard Management Company, September 2015. 12) Annual Endowment Report, Harvard Management Company, September 2014. 13) As of 2017, the Harvard Management Company has discontinued reporting results by asset class.

estate allocation of 14.5%.[10] That followed a real estate return of 19.4% in fiscal 2015[11] and 13% in fiscal 2014.[12,13]

Meanwhile, the $27.2 billion Yale University endowment generated overall annual average returns of 12.1% over the last 20 years.[14] That bested both stock and bond returns over the same period.[14] Real estate, which accounts for roughly 10% of the portfolio, provided average annual returns of 10.3% over the last 20 years.[14] Similarly, real estate owned by CalPERS, which is targeting about 11% of its $326 billion in assets under management toward real estate, returned 7.4% through June 30, 2017.[15]

In Conclusion

Tough investment climates are going to come and go, and the current market environment may discourage individuals who lack the experience and resources available to the smart money funds. Yet by following diversification strategies employed by those institutional investors, individuals are seeking similar return and volatility characteristics.

Owning investments comprised of real estate may be one of the easiest ways individuals can diversify their portfolios. While most lack the resources to buy well-located and occupied retail, office or industrial properties in growing markets, they can still enjoy the potential benefits of those investments by buying real estate investment trusts (REITs). In particular, for individuals not seeking highly liquid vehicles, investing in non-listed REITs, which don't experience the day-to-day volatility of the stock market caused in part by external irrational political and social factors, may be a suitable diversification strategy.

14) Investment return of 11.3% brings Yale endowment value to $27.2 billion, Yale News, October 2017. 15) 2016-17 Comprehensive Annual Financial Report, CalPERS, 2017.

All investing contains risk including loss of principal and no investment strategy can protect against loss or guarantee positive results. Non-listed REITs should be considered long-term investments. Shareholders should be aware that returns and volatility may not have a favorable effect on their portfolio. Prospective shareholders should consider their ability to withstand the lack of liquidity and price transparency. CIM believes the historical performance and correlation of commercial real estate compared with other asset classes is, however, relevant to evaluating an investment in a non-listed REIT comprised primarily of commercial real estate assets.

Consider These Risk Factors Before Investing

This is neither an offer to sell nor a solicitation of an offer to buy interests in any Cole REIT program. Offerings are made only to qualified investors by means of a prospectus.

There are a number of risk factors to consider as you explore non-listed REIT offerings. Some of the risks associated with investing in non-listed REITs include, but are not limited to:

- An investment in non-listed REIT involves a high degree of risk. Prospective shareholders should purchase shares of its common stock only if they can afford a complete loss of their investment.
- The REITs start as a "blind pool," as they have not identified all of the properties they intend to purchase, and the REITs have a limited operating history.
- Absence of a public market for these non-listed securities, the lack of liquidity and an expected investment time horizon in excess of seven years, if at all. Additionally, the REITs are not required, through their charters or otherwise, to provide for a liquidity event.
- There is no guarantee that shareholders will receive a distribution. Distributions have been paid from the proceeds of the offering, from borrowings, and may be derived from the sale of assets, and there is no limit on the amounts that may be paid from such other sources. Payments of distributions from sources other than cash flow from operations reduce the amount of capital available for real estate investments and may decrease or diminish an shareholder's interest.
- There are conflicts of interest facing the REIT, its advisors and its affiliates, including payment by the REIT of significant fees to the advisor and its affiliates.
- Dependence on an advisor to select investments and conduct operations for the REIT. There can be no guarantee that it will meet its investment objectives.
- Economic factors may adversely affect the commercial real estate market, including: changes in the economy, tenant turnover, interest rates, availability of mortgage funds, operating expenses, cost of insurance and each tenant's ability to continue to pay rent.
- The use of leverage during the offering period could limit the amount of cash available to distribute to investors and could result in a decline in the value of an investment in the REITs.
- If a REIT fails to qualify as a REIT, it will be subject to federal income tax. The NAV and cash available for distribution to that REIT's stockholders could materially decrease and adversely affect the return on an investment.

Commercial real estate performs differently than other asset classes, such as stocks or bonds, and lacks liquidity. An investment in a non-listed REIT is not a direct investment in commercial real estate.

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